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DOW THEORY LETTERS

"THE MARKET AS INTERPRETED UNDER THE DOW THEORY"

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TWO METHODS. In the last few weeks I have had occasion to speak to many readers of these letters. A good percentage of them had elected not to sell any securities during the entire January-February decline. They had noted the sentence in Letter #54 which stated, "I want to stress that in the event of a reaction this bull market will not have ended." These investors were willing to sit through any reaction knowing that higher prices would eventually prevail. With this in mind, they were certainly entitled to hold their security lines intact.

Other readers took profits near the highs of A (see chart) or at the point where the B decline lows were violated by both averages. These traders preferred to avoid a possible secondary reaction and were willing to pay the cost of "insurance" against what might have been a serious threat to their portfolios. Sales were made in the knowledge that although the averages were flashing danger signals, history shows that in such areas there is no certainty as to whether (1) a severe secondary reaction will occur, (2) a period of more uncertainty will follow, (3) a decline of perhaps 10 to 40 points will ensue. As it happened, a 23 point decline did take place.

WISHES. In speaking to a few subscribers, however, I learned that they had taken profits, but having taken them, they had then allowed their wishes or preconceived notions to override the implications of the averages. This is the crowning error of the Dow Theorist, and it is well to discuss it now. These sellers had reduced their holdings and then commenced hoping for a reaction. They ignored the diminishing volume on the C-D decline, they ignored the buy-spot of February 12 when volume all but disappeared, and despite Letter #56 they disregarded the second and more obvious buy-spot of February 18. On this latter buy-spot volume had again diminished, and it had become rather obvious that the selling was over

I explained in Letter #56 that the E-F formation was an imperfect buying area, but on February 18 on the second test (F-G) of the lows, there was no reason for traders to refrain from adding to their lines. Here for the second time volume dried up as the averages declined, and those who did not make purchases here were not operating on Dow's Theory. Regardless of the fact that many people were hoping to buy stocks in the 530-50 area on the D-J Industrial Average, the verdict of the market was that they would not have the opportunity of doing so on this round.

GREED. Greed can cause some investors to overstay an advance; it can also cause others to resist a bullish market in the hope of making purchases at much lower prices. The latter want the safety of avoiding possible reactions, but once having paid their taxes and commissions they demand vastly lower prices before coming in again. In such cases they may or may not get their wish. When a man pays the cost of fire insurance he does not fret because his house refuses to burn down.

Rhea knew this when he wrote, "In my opinion that most common of all human traits, greed, is the factor which most militates against successful speculation. Greed causes us to try to read into the averages clues which do not exist. Greed causes us to 'beat the gun' by guessing at the tops and bottoms; it makes us reluctant to accept losses; it causes us to grab small profits for fear they will vanish; moreover, it makes sold-out bulls buy again near the culmination of rallies."

This writer, as a matter of fact, has at one time or another been guilty of all of the above.

TECHNICAL POSITION OF THE MARKET. Periodically these Letters review the technical position of the market. Under orthodox Dow Theory the technical position is discounted in

the averages, and I happen to subscribe to this point of view. I always give the highest priority to the movements of the averages, regardless of what others may claim as to the market's technical strength or weakness. Hamilton, in fact, believed that even volume is discounted in the price movements, and that at best volume is an aid in predicting the direction of the averages. Nevertheless, technical aids can be valuable and should not be ignored.

THE SHORT INTEREST has receded rather sharply during the last few months, but the ratio of total shorts to the average daily volume is the really significant figure. Each short seller affects the market since he must some day be a buyer. Investors who are long stocks do not affect the technical position of the market since theoretically they do not ever have to sell. The current ratio between the total short interest (which must eventually be covered) and the average daily volume is now 1.18. This figure can be considered to be in the neutral zone. Anything above 1.5 is bullish, and a ratio of below .5 is definitely bearish. The total short interest hit its historic highs (over six million shorts) last July, 1958, and has been decreasing slowly ever since. This is normal, however, and during the 1954-56 rise the total short interest diminished steadily for nineteen months before the advance finally ran out.

THE YIELD on the D-J Industrials is now 3.33%, lowest since the pinnacle of the 1942-46 bull market. That market topped out on a yield of 3.2%, but as this is a more speculative affair it is entirely possible that yields could go to 3.0% or less at the highs of the current third phase. In 1929 the D-J Industrials yielded 3.1% at the top, and the 1932-37 bull market expired at 3.7% yield. Some readers may remember that Dow said that stocks yielding less than 3.5% were relatively unattractive to investors.

THE LOW-PRICED STOCK INDEX has always been one of the best guages of speculative sentiment. During the past eight months I have constantly drawn readers' attention to this indicator. Because of the large number of new subscribers and because of the dynamic situation in cheap stocks at this time, I feel that this study deserves reviewing.

During the entire January-February decline in the averages, Barron's Low-Priced Stock Index actually rose a few points against the market. In the week ending February 20, Barron's Index jumped an amazing 14 points to 225.4. This indicates a steady flow of speculative funds entering the market in search of low-priced "bargains." Because Standard & Poor's Index goes back to 1926 we will use it for purposes of bull market comparisons. Readers should study the chart on page 4. Note that the low-priced stocks make their great moves during the last year to year and a half of a bull market, or in that portion of the market which roughly corresponds to the third phase.

In the bull market of 1921-29 (see chart) it was not until 1928 that the cheap stocks began their spectacular advance while the S.& P. list of 500 stocks (indicative of the general market) sloped gently upwards. During the 1932-37 bull market the low-priced stocks headed up in late 1936, only to top out approximately six months later. The 1942-46 bull market did not have its "cat-and-dog" advance until late 1945. And to bring matters to the present, the chart will show that cheap issues began heading skyward just after October, 1957, in that period which we have labeled as the beginning of the third phase of the current bull market. S.& P.'s Low-Priced Index has recently rushed into the 75-80 area, a height never before attained.

It becomes obvious then, that we are now in the midst of the most speculative phase of a bull market since 1945. As I have stated many times in recent Letters, the great percentage gains from here will be made by the "cats-and'dogs, not the "blue chips." There is nothing unique in this phenomonon; it has occurred near the highs of every extended bull market in the history of the averages.

Readers who wish to assume the risk of owning "cats-and-dogs" might purchase a few of the following stocks and hold them until this market shows signs of boiling enthusiasm.

This might easily occur in the next three months to a year. LOW-PRICED SPECULATIONS: SYMINGTON WAYNE, BALDWIN-LIMA-HAMILTON, LOWENSTEIN, UNITED MERCHANTS, HUPP, SPARTON, CONTINENTAL MOTORS, HOTEL CORP., CURTIS PUBLISHING, COTY, SCHICK, AMERICAN CABLE, U.S. INDUSTRIES, GENERAL INSTRUMENTS, ADMIRAL, FAWICK, AVCO, LIST INDUSTRIES, GREAT AMERICAN INDUSTRIES.

It might be instructive and perhaps prophetic to listen to Robert Rhea's account of the final phase of the 1929 bull market. "During the last three months of the excitement it was not unusual for a stock to advance more in one week than it could earn in five years. It was obvious that stocks were quoted on hopes and expectations, rather than on any reasonable appraisal of the present or future value. Stocks having negative book value were advanced faster than "blue chips." Bonds which were first mortgages on the earnings and physical assets of corporations were, in many cases, yielding far more than the common stocks of these companies."

THE END OF THE BULL MARKET OF 1896-99. In a recent Letter I explained that it would be instructive to study the manner in which previous bull markets had topped out, particularly in view of the fact that we are now in the midst of the third phase of history's greatest bull market. The first bull market of which we have any careful record ended as follows:

The final bull swing began in March, 1898, and continued to April, 1899. Volume ran as high as 6 to 8 million shares daily during the last six months of 1898, which was an incredible figure for those days. The first ominous signs appeared towards the end of this huge swing. During the first 14 weeks of 1899 the averages diverged (moved in opposite directions) on no less than 30 different days. Volume in mid-January, 1899 (the market was still climbing) suddenly dropped off and continued relatively low. Thus Dow Theorists would have recognized two distinct danger signals.

At the highs call money went to 10%, speculation was feverish, and newspapers waxed poetic as industrial records were shattered in all areas. An actual quote from a newspaper of the times reads, "Bright Days Ahead for Trade--Proof of Growing Business on Every Hand." Another headline states, "Steel Mill Records Broken." As is usually the case towards the end of a bull market, the economy appeared rosy.

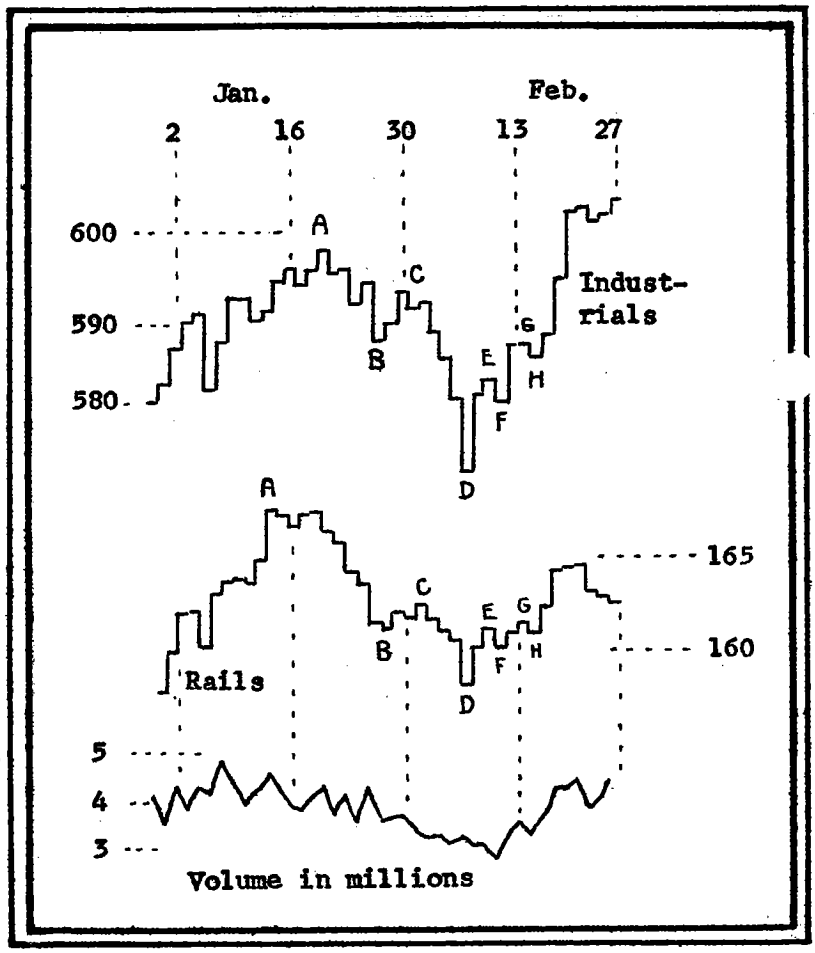
In April, 1899, both averages hit their highs, declined slightly, then formed a "line" (obviously of distribution) just under the highs. When the averages broke this line downside it proved to be the beginning of a secondary reaction that was later classified as the first leg of a new bear market. This was one of the two bear markets in history which retraced less than 50% of the previous entire bull market. The other, of course, was the bear market of 1946-47.

DOW THEORY. The market has appeared quite strong since our last Letter. Volume for the first time since mid-January is behaving bullishly, increasing on advances and diminishing on declines. The rails have been the "fly in the ointment," having steadfastly refused to better their previous 167.38 highs (point A on chart). Thus they have not confirmed the industrial advance through their own A highs. Rails have been moving "in gear" or in the same direction with industrials, which is usually a good sign. But to make matters difficult, last Thursday and Friday rails diverged, declining slightly on both days while industrials edged forward to new highs. Considering the unconfirmed rail high and the two consecutive days of divergence, Dow Theorists should be on the alert. Rails will either follow the industrials up or industrials will decline with the rails. The two averages have never travelled separate paths for long.

It is possible that the two averages will test the D lows (indust. 574.46; rails 157.94) before attempting a further advance. (By "test" I mean any downward movement, preferably of two days or longer.) If the averages decline on diminishing volume, and one or both hold above the D lows, this will constitute another buy-spot. If both averages should decline on

increasing volume and the D lows are violated, it would be an exceedingly bearish omen and could very well mark the beginning of a secondary reaction. Ordinarily, after the low volume on the January-February decline, I would not hesitate to opine that the next broad movement of the market will be up. But because of the uncorrected 183 point advance since October, 1957, and because of the current rail hesitancy I would rather let the averages tell the story from here on. An "in gear" advance by both averages from this area would imply that the rails will better their previous highs at point A. This would be the bullish confirmation which all recent buyers of stock now require.

However, even if rails now better their highs at A, I would not consider it an important bullish signal because of the time lag involved in confirmation as well as the previous hesitancy. The most bullish confirmations occur when both averages hurdle critical points within a few days of each other. Following this same line of reasoning, if the rails do better their highs at A their next critical point would be the 181.23 rail bull market high established in 1956. Here again, regardless of the fact that a penetration of 181.23 would constitute a belated primary bull signal, we must consider that industrials bettered their own 1956 highs in September, 1958, almost five months ago. If rails in the next few months confirm the primary penetration made by industrials last September, I would have to consider the performance as more of a sign of a maturing bull market than anything else. Certainly a rail confirmation of the five month old industrial breakthrough would not be a signal for Dow Theorists to make additional purchases.



Remember that buy-spots are areas where following a decline and an advance, another decline takes place but on this second decline volume dries up and one or both averages hold above the lows of the first decline. F and H on chart are examples of buy-spots. In the advent of another buy-spot the following stocks look bullish on my charts:

FIRSTAMERICA CORP, MONSANTO, CORNING GLASS, DOW, MAGMA COPPER, ANACONDA, JOHNS MANVILLE, AMERICAN POTASH & CHEMICAL CORP.
(written March 1, 1959)

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